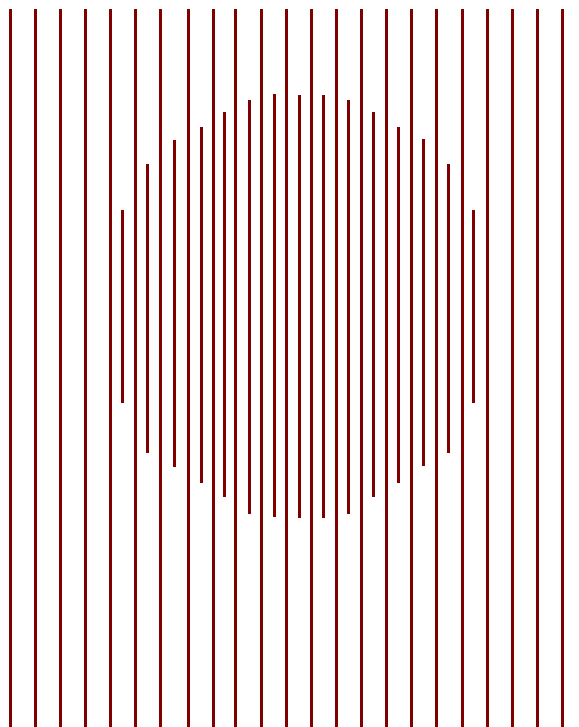


CBO PAPERS

**AN ECONOMIC ANALYSIS OF THE
REVENUE PROVISIONS OF OBRA-93**

January 1994



CONGRESSIONAL BUDGET OFFICE

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SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515**

NOTE

The numbers in the text and tables of this paper may not add to totals because of rounding.

PREFACE

The Omnibus Budget Reconciliation Act of 1993 (OBRA-93) will increase federal tax revenues by \$241 billion between 1994 and 1998. Major revenue-raising provisions in the act include raising marginal tax rates on the highest income individuals, increasing the taxation of Social Security benefits of middle- and upper-income retirees, raising taxes on transportation fuels, raising the top corporate income tax rate, and reducing a number of business deductions. These revenue gains are offset in part by revenue losses from provisions that expand the earned income tax credit for low-wage workers, extend a number of existing tax incentives, introduce some new tax preferences, and repeal some of the luxury excise taxes that were enacted in 1990. Overall, the tax changes in OBRA-93 will affect incentives to work, save, and invest; encourage some selected forms of economic activity; and alter the distribution of the tax burdens among income groups.

In this paper, the Congressional Budget Office (CBO) presents an economic analysis of the major revenue provisions of OBRA-93. The paper discusses how the act affects economic incentives, assesses some of the potential behavioral responses, provides estimates of changes in the distribution of the tax burden among taxpayers in different income and demographic groups, and discusses selected impacts of the act such as the effects on small business.

Eric Toder of CBO's Tax Analysis Division prepared the final draft of the paper, under the direction of Rosemary Marcuss. Mark Booth, Maureen Griffin, Matthew Melillo, Larry Ozanne, Linda Radey, Pearl Richardson, and David Weiner wrote sections of the paper on separate aspects of the legislation. Rick Kasten, Frank Sammartino, and David Weiner provided estimates of the distribution of the tax burden. James Blum, Leonard Burman, and Robert Dennis provided useful comments on earlier drafts of the paper.

Sherwood Kohn edited the manuscript and Christian Spoor provided editorial assistance. Simone Thomas prepared the paper for publication.

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CHAPTER I

INTRODUCTION

The Omnibus Budget Reconciliation Act of 1993 (OBRA-93) relies on tax increases for much of its reduction in the deficit. The Congressional Budget Office estimates that OBRA-93 will reduce the deficit by \$433 billion between 1994 and 1998. Of this amount, \$241 billion (56 percent) will come from increased tax revenues, \$77 billion (18 percent) from cuts in mandatory spending, \$69 billion (16 percent) from cuts in discretionary spending, and \$47 billion (11 percent) from lower debt-service costs.

OBRA-93's changes in spending and taxation will reduce the amount of fiscal stimulus that the federal budget would otherwise supply. This tighter fiscal policy, unless offset by easier monetary policies, can slow the recovery in the short run by reducing demand for the economy's output by government and private consumers. At the same time, the reduced federal demand for private credit will keep interest rates lower than they would otherwise be and reduce the need to borrow from abroad. Lower interest rates and less foreign borrowing will increase both domestic investment and net exports. Ultimately, by increasing national saving and the accumulation of wealth, the lower deficits that OBRA-93 produces will increase U.S. living standards.

In addition to the macroeconomic effects of deficit reduction, the revenue provisions of OBRA-93 will change the distribution of tax burdens among income and demographic groups and alter incentives that affect work effort, saving, investment, and the composition of business activity. Through these incentives, the changes in the tax law will influence how efficiently the economy uses labor and capital.

The revenue provisions of OBRA-93 will raise \$241 billion between 1994 and 1998 (see Table 1). This includes a \$268 billion gain from provisions that raise revenue and a \$28 billion revenue loss from other provisions. In addition, the expansion of the refundable portion of the earned income tax credit (EITC) increases mandatory spending by \$19 billion in 1994-1998. Counting the full effect of the EITC, the tax reductions in OBRA-93 increase the deficit by \$47 billion between 1994 and 1998, and all of the tax law changes combined reduce the deficit by \$221 billion.¹

1. Current budgetary procedures record the effects of the EITC in two places. The budget counts the part that offsets other tax liability as a reduction in revenue. But the budget counts the refundable portion--the amount of the credit that exceeds other tax liability for any taxpayer--as a budget outlay instead of a tax reduction. The budget convention is that no one pays a negative amount of taxes; net tax refunds are spending. The expansion of the EITC in OBRA-93 offsets other taxes by under \$2 billion in the 1994-1998 period, but increases refundable credits by \$19 billion.

TABLE 1. BUDGETARY SAVINGS FROM MAJOR TAX PROVISIONS OF OBRA-93
(By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998	Five- Year Total
Major Revenue-Increasing Provisions						
Increase tax rates paid by high-income individuals ^a	15.4	22.8	25.7	24.6	26.3	114.8
Repeal Hospital Insurance wage base cap	2.8	6.0	6.4	6.8	7.2	29.2
Increase taxable portion of Social Security benefits	1.9	4.6	5.3	6.0	6.7	24.6
Increase motor fuels tax by 4.3 cents per gallon	4.8	4.9	4.8	4.8	4.9	24.3
Increase corporate tax rate to 35 percent for taxable income above \$10 million	4.4	2.8	2.9	3.0	3.2	16.4
Reduce deductible portion of business meals and entertainment expenses	1.8	3.1	3.3	3.4	3.6	15.3
Extend current 2.5 cents per gallon motor fuels tax	n.a.	n.a.	2.6	2.6	2.6	7.8
Extend and modify corporate estimated tax rules	2.1	0.4	0.1	4.3	0.9	7.8
Other revenue-increasing provisions	<u>1.7</u>	<u>4.8</u>	<u>5.8</u>	<u>9.0</u>	<u>6.6</u>	<u>27.9</u>
Total	34.9	49.4	56.9	64.7	62.1	268.0
Expansion and Simplification of the EITC						
Revenues	b	-0.2	-0.4	-0.5	-0.6	-1.7
Outlays	<u>-0.2</u>	<u>-2.0</u>	<u>-4.4</u>	<u>-6.1</u>	<u>-6.4</u>	<u>-19.1</u>
Total	-0.2	-2.2	-4.8	-6.7	-7.0	-20.8
Other Tax Incentive Provisions						
Extend low-income housing credit	-0.4	-0.6	-0.9	-1.3	-1.7	-4.9
Extend research and experimentation credit	-2.2	-1.2	-0.8	-0.4	-0.3	-4.9
Increase expensing amount for small business to \$17,500	-2.3	-1.0	-0.7	-0.4	-0.2	-4.6
Eliminate ACE depreciation adjustment under corporate AMT	-0.3	-1.0	-1.1	-1.0	-0.9	-4.3
Provide passive loss relief for real estate professionals	-0.3	-0.5	-0.5	-0.6	-0.7	-2.6
Provide tax incentives for empowerment zones and enterprise communities	-0.3	-0.5	-0.5	-0.6	-0.6	-2.5

(Continued)

TABLE 1. CONTINUED

	1994	1995	1996	1997	1998	Five- Year Total
Other Tax Incentive Provisions (Continued)						
Extend mortgage revenue bonds and mortgage credit certificates	-0.1	-0.1	-0.2	-0.3	-0.3	-1.0
Other incentive provisions	<u>-1.8</u>	<u>-0.7</u>	<u>-0.1</u>	<u>0.2</u>	<u>0.5</u>	<u>-1.9</u>
Total	-7.6	-5.6	-4.9	-4.4	-4.2	-26.7
Other Revenue Provisions	-0.9	-0.2	-0.1	0.8	1.1	0.8
Summary of Revenue Changes						
Revenue-increasing provisions	34.9	49.4	56.9	64.7	62.1	268.0
Revenue loss from tax incentives	-7.6	-5.8	-5.3	-5.0	-4.8	-28.4
EITC	b	-0.2	-0.4	-0.5	-0.6	-1.7
Other tax incentives	-7.6	-5.6	-4.9	-4.4	-4.2	-26.7
Other revenue provisions	<u>-0.9</u>	<u>-0.2</u>	<u>-0.1</u>	<u>0.8</u>	<u>1.1</u>	<u>0.8</u>
Total revenue change	26.4	43.5	51.5	60.7	58.5	240.6
Increased Outlays from EITC	-0.2	-2.0	-4.4	-6.1	-6.4	-19.1
Net Budget Savings from Tax Law Provisions	26.2	41.5	47.1	54.6	52.1	221.5

SOURCE: Congressional Budget Office.

NOTE: OBRA-93 = Omnibus Budget Reconciliation Act of 1993; n.a. = not applicable; EITC = earned income tax credit; ACE = adjusted current earnings; AMT = alternative minimum tax.

a. Includes the imposition of new rate brackets of 36 percent and 39.6 percent; the increase in the tax rates and exemption amounts under the individual alternative minimum tax; and the extension of the itemized deduction limitation and personal exemption phaseout.

b. Less than \$50 million.

Increases in income tax rates on high-income individuals are the largest single revenue item, producing about \$115 billion in additional revenues between 1994 and 1998. OBRA-93 imposes new marginal income tax rates of 36 percent and 39.6 percent on high-income individuals, increases the tax rates under the alternative minimum tax (AMT) for individuals, and permanently extends the limitation on the use of itemized deductions and the phaseout of personal exemptions. Other major revenue-raising provisions repeal the cap on earnings subject to the Hospital Insurance payroll tax (\$29 billion), increase the taxable portion of Social Security benefits for middle- and upper-income retirees (\$25 billion), increase the motor fuels excise tax by 4.3 cents per gallon (\$24 billion), increase the top corporate income tax rate to 35 percent (\$16 billion), reduce the deductible portion of business meal and entertainment expenses (\$15 billion), and extend the current 2.5 cents per gallon motor fuels tax beyond its scheduled expiration date of October 1, 1995 (\$8 billion). Modification of the corporate estimated tax rules also raises \$8 billion between 1994 and 1998, but this increase can be attributed to the one-time effect of advancing the timing of tax payments.

The largest single deficit-increasing tax provision is the expansion of the earned income tax credit for low-income workers (\$21 billion, of which \$19 billion is counted as an increase in outlays). The largest revenue-losing provisions are those that extend the low-income housing credit and the research and experimentation credit (\$5 billion each), increase the annual amount of investment that small businesses can deduct immediately or "expense"--to \$17,500 (\$5 billion), eliminate the adjusted current earnings method of depreciation under the corporate alternative minimum tax (\$4 billion), allow real estate professionals to claim passive losses (\$3 billion), and introduce new tax incentives for investment and employment in empowerment zones and enterprise communities (\$2 billion).

OBRA-93 includes many other provisions with smaller revenue consequences, but these provisions substantially affect some taxpayers and business decisions. The law extends several existing tax preferences that encourage selected forms of investment and employment, and eliminates or reduces other tax preferences and restricts deductions for some business expenses. It repeals the luxury tax on boats, aircraft, jewelry, and furs; indexes the luxury tax on automobiles for inflation; extends the 25 percent deduction for health insurance for self-employed individuals; and permanently removes gifts of appreciated property to charities from the AMT.